State of Washington
DEPARTMENT OF FINANCIAL INSTITUTIONS
DIVISION OF CREDIT UNIONS
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April 27, 2005

"A", Chair and
Board of Directors
"B" Credit Union

Corrected letter

Interpretive Letter I-05-05 redacted: Conflict of interest by candidates for board of directors or supervisory committee positions

Dear "A":

Thank you for your phone call. You have sought our guidance on how to handle possible conflicts of interest by candidates for board of directors or supervisory committee at "B" Credit Union, as described below:

- An outstanding payment dispute between "B" Credit Union and a former employee, and

- The involvement of a candidate for the board of directors or supervisory committee with ongoing litigation between "B" Credit Union and "C" Committee.

Your request raises the following issues:

1. Does a candidate's involvement in litigation pending against the credit union or a payment dispute with the credit union create a conflict of interest?

2. Must the "B" Credit Union board of directors disclose these conflicts of interest of the litigation pending against the credit union or a payment dispute with the credit union in materials sent to members for the election of board or supervisory committee members?

3. Does the Division of Credit Unions have the authority to regulate this issue of corporate governance?

Background

The board of directors and supervisory committee of "B" Credit Union have recently changed composition after a 2004 election. This change in board composition occurred following an attempt by the previously constituted "B" Credit Union board of directors to convert "B" Credit Union to a state-chartered savings bank. In 2004, the National Credit Union Administration (NCUA) concluded that "B" Credit Union had not complied with §708a of the NCUA Rules and Regulations, and that "B" Credit Union would have to undertake another membership vote if it intended to continue to pursue conversion.

During the controversy over the charter conversion, a group of members formed a non-profit corporation, the "C" Committee, which brought a lawsuit against "B" Credit Union related to the conversion. In the 2004 election of the board of directors and supervisory committee, several members of "C" Committee won election to office, resulting in slightly less than a majority on the board and a majority on the supervisory committee.

Some of the 2005 candidates for positions on the board and supervisory committee are members of "C" Committee, which is involved in ongoing litigation against "B" Credit Union.

Another candidate for a board position is a former employee of the credit union who is currently involved in a payment dispute with "B" Credit Union.

Issue 1: Does a candidate's involvement in ongoing litigation against "B" Credit Union or a payment dispute with "B" Credit Union constitute a conflict of interest?

Analysis

The law generally presumes that a board member will act in good faith and with prudent business judgment.[1] The common law "prudent business judgment" rule is essentially embodied in the Washington Credit Union Act, as follows:

> Directors, board officers, and senior operating officers are deemed to stand in a fiduciary relationship to the credit union, and must discharge the duties of their respective positions:
>
> (1) In good faith;
>
> (2) With the care an ordinarily prudent person in a like position would exercise under similar circumstances; and
>
> (3) In a manner the director or officer reasonably believes to be in the best interests of the credit union.

RCW 31.12.267.

This presumption may be rebutted upon a showing that a director:

- Has not actually deliberated;
- Is uninformed;
- Is otherwise not disinterested or independent*;* or
- Has acted in a "grossly negligent" manner.[2]

The presumption that a board or supervisory committee member will act in good faith is based in part on the concept that a director will exercise independence of judgment. Independence means that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences. The end result must be that each director has used his own informed business judgment to decide the merits of the issues without succumbing to influences that are not in the best interests of the corporation.[3]

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[1] *Fletcher Cyclopedia of the Law of Private Corporations*, § 1036; Aronson v. Lewis 473 A.2d 805, 812 (Del. 1984); FDIC v. Castetter 184 F.3d 1040 (CA 1999).

[2] *Fletcher Cyc. Corp.*, supra; Aronson v. Lewis, supra; FDIC v. Castetter, supra.

[3] *Gilbert v. El Paso Co.*, 575 A.2d 1131, 1147 (Del. 1990).

Where a nominee for the board or supervisory committee is involved in litigation against the credit union or has a payment dispute with the credit union, they clearly have an interest contrary to that of the credit union with regard to those issues. They are not disinterested or independent as to those issues. As a result, there is clearly a conflict of interest between the nominee and the credit union. The nominee's conflict of interest remains as long as the current disputes are pending.

Conclusion

It is presumed that a future board or supervisory committee member will act in good faith and with prudent business judgment; unless it can be shown that the nominee has a conflict of interest, or will not act with disinterest or independence in a particular transaction. A board nominee who is involved in litigation against the credit union or has a payment dispute with the credit union has a conflict of interest.

Issue 2: Is the "B" Credit Union board of directors required to disclose these conflicts of interest of nominees, arising from involvement in the litigation pending against the credit union or a payment dispute with the credit union, in materials connected to the election of board members?

Analysis

In order for a credit union's board of directors to properly exercise its fiduciary duty to all members, the board should ensure disclosure of a candidate's conflicts of interest arising from involvement in litigation pending against the credit union or a payment dispute with the credit union in election materials to the credit union's members.

This principle is underscored by a fundamental rule of corporate law, stated as follows:

> A board's duty of complete candor to its shareholders to disclose all germane or material information applies to matters of corporate governance as well as to corporate transactions.
>
> Directors are under a fiduciary duty to disclose fully and fairly all material information within the board's control when it seeks shareholder action.[4]

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[4] *Fletcher Cyc. Corp.* § 837.70.

The election of board and supervisory committee members requires action by the credit union's members, who are comparable to the shareholders of a for-profit corporation. The involvement of a board or supervisory committee nominee in pending litigation or a payment dispute with "B" Credit Union is information that is germane and material to the credit union's present and future corporate governance matters (such as litigation and settlement). Therefore, directors of the credit union are under a fiduciary duty to fully and fairly disclose the existence of such conflicts of interest.

This disclosure should be included in the voting materials disseminated to credit union members prior to the election. The requirement can be met either by the candidate including information about the conflict in his or her candidate statement, or by the credit union including the information in the election packet disseminated to members. If the candidate chooses to include the conflict information, he or she may state, for example, "I belong to an organization called "C" Committee. This organization is in ongoing litigation with "B" Credit Union" or "I am a former employee of "B" Credit Union, and I am in negotiations with the credit union regarding payments to me."

Conclusion

"B" Credit Union's board of directors owes its members a fiduciary duty of complete candor with respect to any germane and material information that may apply to corporate governance when it seeks shareholder action. A board or supervisory committee candidate's conflict of interest regarding pending litigation against "B" Credit Union or a payment dispute with the credit union are issues that are germane and material to questions of current and future corporate governance. Therefore, this information should be disclosed to credit union members in election materials disseminated before the annual meeting at which the board and supervisory committee will be elected. The conflict may be disclosed by the candidate in his or her statement, or by the credit union in the election information disseminated to members.

Issue 3: Does the Division of Credit Unions have the authority to regulate and enforce the principles of corporate governance set forth above?

Analysis

As discussed more thoroughly in Issue 2 above, directors of a credit union have a fiduciary relationship to the credit union and must act in good faith and with prudent business judgment. RCW 31.12.267. The director of the Department of Financial Institutions, as delegated to the Division of Credit Unions, has the authority to require credit unions to conduct business in compliance with the Washington State Credit Union Act (Act). RCW 31.12.516(1). The director also has the authority to interpret the provisions of the Act. RCW 31.12.516(3). Therefore, the Division may require a credit union board of directors to disclose a candidate's conflict of interest to members prior to the election of the board and supervisory committee.

Conclusion

The Division of Credit Unions has the authority to require a credit union to disclose a board or supervisory committee candidate's known conflicts of interest arising from involvement in litigation against the credit union or a payment dispute with the credit union in election materials sent to members prior to the election.

Sincerely,

Linda K. Jekel
Director of Credit Unions